any sense be said to be biased in a policy direction--that is, against foreign entanglements.

Most of the proposed Constitutional amendments to limit deficits or expenditure growth provide for overriding the amendment's prohibition in case of war or a national emergency declared by a super-majority, that is, a vote of three-fifths, two-thirds, or three-fourths of the total membership of each House. Most commentators have viewed these provisions as escape clauses. But they can also be viewed as a fundamental change in the rules of the game. The most important effect of the escape clauses is that they shift decisionmaking on budget questions from a simple majority of those voting to a two-thirds or three-fourths majority of the total membership.

It is difficult to predict the effect of such a shift. It is worth noting, however, that the House of Representatives has yet to pass a budget resolution by a two-thirds majority. If the voting requirement for passage of a budget deficit became more stringent, moreover, the probability that any given Member or group of Members could demand a specific legislative concession for their votes might increase.

Finally, it is also worth noting that under the options discussed below the United States could declare war--which takes a simple majority vote--much more easily than it could deliberately run a deficit or exceed certain growth rates in expenditures or revenues. The central question is whether the economic and social benefits of these prohibitions are worth such a fundamental change.

OPTIONS REQUIRING A BALANCED BUDGET

The various bills and Constitutional amendments that have been introduced to limit or prohibit federal budget deficits differ as to:

> United States, or under any State, who, having previously taken an oath, as a member of Congress, or as an officer of the United States, or as a member of any State legislature, or as an executive or judicial officer of any State, to support the Constitution of the United States, shall have engaged in insurrection or rebellion against the same, or given aid or comfort to the enemies thereof. But Congress may, by a vote of two-thirds of each House, remove such disability.

- Who is responsible for achieving the balance and how the prohibition of deficits is to be enforced.

- What is prohibited--that is, under what conditions is the budget considered in deficit.

- Whether the balance must be achieved annually.

- What, if anything, is done about retiring the existing public debt.

- Whether a phasing procedure is included in the bill or Constitutional amendment.

Who Is Responsible for Balancing What?

Most of the proposed bills and amendments require the Congress to assure that the federal budget is balanced. Under current budgetary procedures, however, the Congress has limited control over the actual amount of federal expenditures and revenues that are spent and collected each year.

On the spending side, the Congress grants authority to the Executive Branch to enter into obligations. These obligations are commitments by the federal government to the prospective beneficiaries, and, when they have to be fulfilled, the Treasury makes the necessary payments. Thus, a large part of the actual amount of federal money spent each fiscal year is determined by Executive Branch actions on the authority granted by the Congress.

The Congress has also structured many federal programs so that their expenditures will be sensitive to the economy. Because approximately 40 percent of federal expenditures are adjusted automatically for increases in the price level, a 1 percentage point rise in the rate of inflation will increase federal outlays by as much as $2 billion. A similar relationship holds for increases in the unemployment rate, with a 1 percentage point rise leading to an additional $5 to $10 billion in automatic expenditures.

The Congress also has only indirect control over the amount of tax receipts; it controls tax rates, not levels of revenue. The actual level of revenues in a given year is even more sensitive to economic activity than are expenditures. A 1 percentage point increase in the inflation rate will bring in $5 to $15 billion in additional receipts, while a 1 percentage point rise in unemployment will result in a $20 billion decline in revenues.

How Often Is the Budget to Be Balanced?

Most of the proposals require balanced federal budgets every year. Some, however, aim for the achievement of budget balance over an economic cycle. One option, for example, would allow deficits brought on by changing economic circumstances as long as they were less than 2 percent of expenditures (or a $13 billion deficit in fiscal year 1981) and as long as any deficit was repaid over the next five years. 6/ Such a plan would be less likely to have a destabilizing economic effect than those proposals that would require annual balances.

It is important to remember, however, that a 1 percentage point rise in the unemployment rate would automatically increase the federal budget deficit by $25 billion the first year. This flexible option, therefore, would only allow for a half a percent rise in the unemployment rate before a two-thirds vote of the House and Senate would be required.

Illustrative Options

Option I--Make the Congress Responsible but Only Require that It "Seek to Assure" a Balanced Budget. This option, in effect, would establish the goal of balanced budgets as Congressional policy. While placing the responsibility with the Congress, the option would not prohibit a deficit.

Option II--Make the Congress Responsible and Require that Budget Estimates Be Balanced. One form of this option would prohibit outlays from exceeding revenues in budget resolutions. It would be similar to the 19th century balanced budget rule that planned expenditures should equal planned revenues. Under this option, deficits brought about by changing economic conditions would not be prohibited, but the Congress could not legislate planned deficits to stimulate the economy.

Option III--Make the Congress Responsible by Prohibiting Appropriations, Outlays, or Total Expenditures in Excess of Revenues, or by Prohibiting Any Action that Would Cause an Increase in the Public Debt. Although terms such as appropriations, outlays, expenditures, and public debt are what the Congress says they are, under current Congressional definitions the adoption of any of the

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6/ H.J. Res. 181, introduced by Representative Fithian.

prohibitions in this option would not necessarily guarantee balanced budgets. For example, although the Congress can directly control the level of appropriations every year, such control would not eliminate deficits. Appropriations are one means of granting budget authority. Budget authority, however, is not always spent in the same fiscal year it is granted. Thus, under current practice the Congress enacts much more budget authority for each budget than ends up as outlays that year.

Outlays in excess of revenues is the standard definition of a budget deficit. The problem with a prohibition of outlays in excess of revenues is that the Congress does not directly control the level of either. In practice, therefore, a simple prohibition of outlays in excess of revenues would be the equivalent of Option II.

The term expenditures is frequently used in the proposed bills and amendments. According to the Comptroller General, the term expenditures has the same legal meaning as the term outlays. 7/ Those who have adopted the prohibition of total expenditures exceeding revenues have done so in order to try to control off-budget spending. Achievement of this goal, however, would require further legislation.

In order to comply with the requirement that the public debt not grow, either the budget would frequently have to be in surplus or the trust funds would have to be excluded from the unified budget. Currently, increases in the federal debt result from the combination of the unified budget deficit (if any), the off-budget deficit (if any), and the trust fund surplus (if any). The trust fund surplus is included because, by law, any surplus from most trust funds must be invested in federal securities. It is possible, therefore, to have a unified budget balance and an off-budget balance, but a rise in federal debt, because the trust funds are in surplus.

<u>Option IV--Require the Congress to Achieve a Balanced Budget at the End of Each Fiscal Year</u>. This option would require that periodically throughout the budget cycle and the fiscal year the Congress review estimates of expenditures and revenues and modify

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6/ The Comptroller General of the United States, <u>A Glossary of Terms Used in the Federal Budget Process</u>, third edition (General Accounting Office, March 1981), p. 58.

appropriations and/or tax rates to guarantee that a balanced budget is achieved at the end of the fiscal year. Most of the proposed bills and Constitutional amendments that follow this option incorporate a requirement that a surtax be imposed if it appears that expenditures would exceed revenues. This option is much more likely to have a destabilizing effect on the economy than those proposals that would only require a planned balance (Options I and II).

Option V--Require the Congress to Enact Budget Authority and Tax Rates to Achieve a Balance and Require the President to Ensure a Balance at the End of the Fiscal Year. This option would require that the President or some other official of the Executive Branch be empowered to impose a surtax or impound funds in order to guarantee a balanced budget. Because it would require an actual balance regardless of economic conditions, Option V would probably be destabilizing during some periods. This option also implies a significant shift of budgetary power from the Congress to the President.

OPTIONS FOR LIMITING EXPENDITURE AND REVENUE GROWTH

The proposals that have been introduced to check the growth of federal expenditures differ as to:

- Whether their aim is to maintain the current size of the public sector or to reduce it.
- Who is responsible for limiting growth and how the prevention of excess growth is to be enforced.
- What is included under the limit.
- The formula that is used to control growth.

Size of the Public Sector

The proposed expenditure and revenue limitation measures seek either to prevent increases in the federal sector and revenue burden or to reduce them gradually. Almost all of the suggested formulas can be modified to achieve either goal since they are based on arbitrarily chosen percentages.

Who Is Responsible, Who Enforces?

As with the balanced budget options, expenditure limitations differ as to both the stage of the budget cycle to which the limit is applied and what action is to be taken should expenditures or revenues exceed the formula's limit either through changes in the economy, incorrect budget estimates, or legislative or executive actions. Some of the proposals would simply require that the planned Congressional budget be within the limits while others would require the Congress and/or the President to reduce outlays either by cutting appropriations or by impounding funds if the actual expenditures would exceed the limit.

All of the expenditure formulas would limit the growth of outlays rather than appropriations or budget authority. This means that the Congress would be asked to limit a measure of spending over which it does not have direct control. Switching to formulas that use appropriations or budget authority would not help very much. Appropriations (other than for entitlements) account for only a portion (around 40 percent) of federal expenditures and a large portion of the budget authority in each year's budget is permanently granted.

What Is Included Under the Limit

Most of the proposals seeking to restrict the growth rate or level of federal outlays place a limit on total outlays (which include off-budget as well as unified budget outlays). The proponents' goal is to prevent future Congresses from excluding certain types of budget activity from the limit. Chapter VII discusses whether any Constitutional amendment could prevent the Congress from shifting federal activities from programs included in the unified budget to off-budget agencies, special provisions of the tax code (tax expenditures), federal credit programs, or federal regulations.

It should be noted, however, that several proposals have tried to anticipate some of the "end-runs" that might be tried to circumvent any expenditure limitation. In the 96th Congress, for example, then House Budget Committee Chairman Robert Giaimo introduced H.R. 6021 which would have placed a limit on the total of federal outlays and tax expenditures. In the 97th Congress, H.J. Res. 350 and H.J. Res. 169 would attempt to prevent the Congress from shifting current federal programs to the states by requiring the Congress to provide compensation equal to the costs to the states of additional activities mandated by the federal government. 8/

Rather than establishing as inclusive a limit as possible, some critics of expenditure limitations contend that some truly uncontrollable parts of the federal budget should be excluded from any limit. Robert Hartman, for example, has suggested that any enacted limit be placed on federal outlays less net interest on the public debt. 9/ Hartman argues that, if the object of an expenditure limit is to control the size of public activities or programs, including net interest on the public debt under the limit would result in a misleading notion of the size of the government when the inflation rate varies. For example, in fiscal year 1976 total federal budget outlays equalled 22.2 percent of GNP. By fiscal year 1981 this ratio had increased to 23.0 percent of GNP. This growth, however, was caused totally by the higher cost of borrowing money; outlays minus net interest remained at 20.6 percent of GNP. Federal government activities just kept pace with GNP during this period.

If one believes that the cost of federal borrowing is beyond the control of the Congress, it would make sense to exclude net interest from any limit. Those who advocate expenditure limits, however, argue that the increased cost of money in recent years at least partly results from federal fiscal policy. Moreover, they contend that a major goal of their proposals is to reduce the amount of federal outlays regardless of their controllability. Therefore, if forces beyond the control of the Congress led to an increase in interest payments, the Congress should reduce other programs, raise additional revenues (in the case of a proposal that prohibits deficits), or, by achieving the necessary super-majorities, invoke the escape clause to allow expenditures to exceed the limit. The advocates of limits also point out that the federal government could follow state practices and develop a contingency fund for just such emergencies.

8/ It should be noted that such a provision would imply a significant shift of power from the national government to the states.

9/ Statement by Robert W. Hartman, Senior Fellow, the Brookings Institution, before the Senate Budget Committee Field Hearings on S. 1848, Seattle, Washington, June 4, 1982.

Illustrative Options

All of the expenditure limitation proposals include a formula to determine maximum allowable federal budget outlays for a given year. 10/ Any formula type can be adjusted so as either to stabilize or to reduce the size of the federal sector. Although some of the formulas appear to be quite complex, they can be grouped into the following four options.

Option I--Set a Fixed Maximum Percentage Rate of Growth for Federal Outlays. Depending on the inflation rate, this type of formula could either dramatically reduce the size of the federal sector or provide no effective limitation at all. For example, a maximum 10 percent outlay growth rate would greatly reduce the size of the federal sector in an era of 15 percent inflation while providing considerable leeway for growth in a period of 3 percent inflation.

Option II--Limit Federal Outlays to a Fixed Percentage of an Economic Indicator (for example, GNP, national income, or potential GNP). A major advantage of this class of formulas is that their structure closely corresponds to their goal. That is, since the goal is to limit the federal sector to a proportion of the economy, this type of option uses a percentage of a measure of that economy.

All of the formulas in this group contain measurement problems in that they involve the use of outlay totals and economic statistics that are not complete at the time the Congress makes budgetary decisions. For example, when CBO forecasts the gross national product, it presents its estimate as a range. That range is plus or minus 4 percent around its midpoint. Depending on which end of the range was used, a limit based on a proportion of GNP would span a $30 billion range. 11/

10/ Most of the proposals also include an escape clause that would allow outlays to exceed the limit with a three-fifths, two-thirds, or three-fourths vote of the total membership of the House and Senate.

11/ For example, in its markup of the First Concurrent Resolution on the Budget for Fiscal Year 1981, the Senate Budget Committee took two roll call votes to determine which GNP figure would be used to comply with the S. Res. 380 requirement that

To overcome this difficulty, some of the formulas use economic indicators from previous years. This, in turn, leads to the potential difficulty of selecting an indicator from one part of an economic cycle (for example, an expansion) and applying it to the federal budget during another part (a recession). 12/ Two approaches have been suggested to overcome this problem: the use of a multiyear average of the economic indicators or the use of potential GNP. Both alternatives have the advantage of creating an economic indicator that is not dramatically affected by economic cycles.

Option III--Limit the Growth Rate of Federal Outlays to the Growth Rate of an Economic Indicator. In addition to the measurement problems that are associated with the formulas of Option II, this class could cause two additional problems. First, an incentive would be created for the Congress and the bureaucracy to spend to the previous year's limit.

Second, this type of option could cause a downward bias in the limit over time. If these proposals operate as expected by their sponsors, they would create a new set of political and bureaucratic incentives. In contrast to the current system, which is characterized by the routine adoption of fairly optimistic forecasts of revenues and outlays, these proposals, according to their sponsors, would cause federal budgeting to resemble state and local budgeting in which budget officers tend to adopt conservative estimates of revenues and outlays because of constitutional limits. On the state and local level, this tends to lead to routine surpluses, except during severe recessions.

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it report out an alternative resolution with outlays equaling 21 percent of GNP. Because the higher GNP figure was accepted by the committee, outlays in the alternative budget had to be reduced an additional $10.8 billion to meet the 21 percent of GNP requirement. See First Concurrent Resolution on the Budget, FY 1981, Report No. 96-654, Senate Committee on the Budget, to accompany S. Con. Res. 86, 96:1 (1980), p. 335.

12/ The use of economic indicators from previous years can also have unintended effects during periods of rapidly changing inflation rates since the impact of inflation will be reflected in the economic indicator before it is reflected in budget outlays.

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If these new incentives are created and federal budget planning shifts so that actual outlays tend to be lower than planned outlays, the base on which the following year's limit is produced would be smaller than if actual outlays had hit the limit. Such a continual pattern, over time, would lead to a gradual reduction in the relative size of the federal sector.

Option IV--One of the Above Options Plus a Provision to Reduce the Maximum Rate of Growth Unless the Federal Government Achieves a Certain Inflation Rate. 13/ This option rests on the assumption that the federal government could achieve an inflation rate target if it only wanted to or on the premise that the federal sector should decline over time. These proposals set a target rate for inflation and then penalize growth in spending when the target is exceeded. One problem with this option is that, if the target rate for inflation is below the attainable rate, the formula would continually reduce the relative size of the federal sector while, if the target is set too high, it might become the inflation goal. In any event, a reasonable target would be hard to determine and harder to change.

H.J. RES. 350 AND S.J. RES. 58: COMBINING DEFICIT RESTRICTIONS AND EXPENDITURE AND REVENUE LIMITATIONS

On August 4, 1982 the Senate passed S.J. Res. 58 by a roll call vote of 69 in favor to 31 against. This proposed constitutional amendment would restrain federal deficits and increases in the public debt and limit the growth of federal revenues and outlays. H.J. Res. 350--a similar proposal with some key differences--is now being considered by the House Judiciary Committee. This section discusses these two major proposals that are now before the Congress.

Provisions Restraining Deficits and Increases in the Public Debt

Both S.J. Res. 58 and H.J. Res. 350 would require the Congress to enact a planned budget prior to each fiscal year in which

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13/ For example, H.J. Res. 169, introduced by Representative Jenkins and supported by a subcommittee headed by Milton Friedman of the National Tax Limitation Committee, uses a growth rate formula that would be lowered by one-fourth of a percentage point for every percentage point that the inflation rate in the most recently completed calendar year was over 3 percent.

total planned outlays did not exceed total planned revenues. Both resolutions also set growth limits on revenues based on growth in national income and require that actual outlays not exceed planned outlays. The most important difference between the two resolutions is that S.J. Res. 58 would also require the Congress to ensure that actual total outlays did not exceed actual total revenues by making it extremely difficult to raise the public debt limit to accommodate deficits.

As approved by the Senate Judiciary Committee, S.J. Res. 58 was identical to H.J. Res. 350. The requirement for an actual as well as a planned balance was introduced through a floor amendment by Senators Armstrong and Boren. Under this amendment, the public debt could be increased only through enactment of a bill by at least a three-fifths vote (60 percent) of the whole membership of each House. The original intent of S.J. Res. 58 (and the current intent of H.J. Res. 350) was to establish the norm of a balanced budget by requiring the Congress to plan a balanced budget each year unless the country was under a declaration of war or unless each House chose to enact a planned deficit by a three-fifths vote of their whole memberships. The authors attempted to avoid situations in which the proposals would cause fiscal changes that would be procyclical to changes in the economy. As reported by the Senate Judiciary Committee, S.J. Res. 58 (and the current version of H.J. Res. 350) would allow actual revenues to fall below planned revenues, resulting in an unplanned deficit, should an unanticipated recession occur once the fiscal year began.

When the Senate adopted the Armstrong-Boren amendment, it precluded unanticipated deficits in almost all circumstances. Thus, S.J. Res. 58, as passed by the Senate, would have a much more dramatic effect on the economy than the version of S.J. Res. 58 that was approved by the Senate Judiciary Committee or H.J. Res. 350. Unless the 60 percent vote could be obtained in each House, the Congress would be forced either to reduce expenditures or to raise taxes during recessions. In fact, because of the current statutory requirement that trust fund surpluses be invested in federal securities, under some circumstances the Senate-passed version of S.J. Res. 58 could require three-fifths vote in each House even when the budget is balanced, since such trust fund investments are currently counted as increases in the public debt.

Revenue and Expenditure Limitations

Both S.J. Res. 58 and H.J. Res. 350 would seek to limit the growth of total budget outlays by placing a limit on the growth of total planned revenues in their required planned budget and by requiring that total planned outlays in that budget not exceed the total planned revenues. Both resolutions then would require that the Congress and the President ensure that total actual outlays at the end of the fiscal year not exceed the total planned outlays.

The formula that controls the growth in planned revenues is different in the Senate passed version of S.J. Res. 58 from that in H.J. Res. 350. Under H.J. Res. 350, planned revenues for the upcoming fiscal year could not grow from the revenue base of the current fiscal year at a faster rate than national income grew in the most recently completed calendar year. For example, to determine the revenue limit for fiscal year 1984, the Congress would apply the growth rate of current dollar GNP (a common measure of national income) between calendar years 1981 and 1982 to the current estimate for total revenues for fiscal year 1983.

When it considered S.J. Res. 58, the Senate accepted an amendment by Senators Domenici and Chiles that would modify this formula. This amendment had three major provisions. First, rather than using the growth rate of current dollar national income in the most recently completed calendar year, the Domenici-Chiles amendment substitutes the growth rate of national income "in the year or years ending not less than six months nor more than twelve months" before the fiscal year that is being considered in the planned budget. Second, the Domenici-Chiles amendment inserted a new section requiring the Congress to enforce and implement the other provisions of S.J. Res. 58 through appropriate legislation.

These changes could have two possible effects. First, by substituting a time period for the most recently completed calendar year the Domenici-Chiles amendment created the flexiblity that would be needed should the Congress choose to alter the timing of the fiscal year. More important, by including the words "year or years" and by giving the Congress flexibility to develop implementation statutes, the Domenici-Chiles amendment opens the possibility that the Congress could change the revenue limitation formula through the enactment of a statute. For example, instead of a one-year lagged growth rate, the Congress could enact a statute that uses the average growth rates of the last five fiscal years. The amendment would also allow the Congress to choose what type of year--fiscal, calendar, or some newly defined accounting period--to use in the formula. Thus, although S.J. Res. 58 as enacted by the Senate and H.J. Res. 350 are both examples of expenditure limitation Option III, the specifics of their limitation formulas could vary.

As with the other proposals under expenditure limitation Option III, S.J. Res. 58 and H.J. Res. 350 would attempt to overcome estimating problems by adopting a limit on revenue growth based on data from a completed prior year. Because that growth rate is applied to a revenue base of a fiscal year that is still under way, however, estimation problems are not totally avoided. Assuming that the planned budget would be developed in the spring of each calendar year, the fiscal year that would be used to determine the revenue base would be only half over. Because of the sensitivity of revenues to economic assumptions--a given change in real growth leads to four times the dollar change in revenues as compared to outlays--the Congress could use different assumptions in order to increase the size of the revenue--and thus the outlay--limit in the planned budget.

The revenue limit, and thus the outlay limit, of both proposals could be raised by legislation enacted by a majority of the whole number of each House and signed by the President. Thus, S.J. Res. 58 and H.J. Res. 350 would allow majorities (albeit majorities of the whole number of Congressmen and Senators rather than a majority of those present and voting) to increase the size of the public sector. The majority of the Congress would have to go on record in order to increase the size of the federal sector. Moreover, the Congress might have to vote to increase taxes to accomplish this.

The framers of S.J. Res. 58 and H.J. Res. 350 apparently intended the separate vote to raise taxes above the limit to serve another purpose, namely, to prevent the tax increases that occur when inflation pushes taxpayers into higher marginal tax brackets. Since these proposals were introduced, however, the individual income tax has been indexed (effective in 1985) to the inflation rate to eliminate "bracket creep."

S.J. Res. 58 and H.J. Res. 350 also would require that a law be enacted to allow the federal government to collect receipts above the revenue limit even when the tax code needed no change. For example, under the formula of H.J. Res. 350, if the estimate of receipts, based on the existing tax code, in the planned budget was greater than the limit on receipts, the Congress either would have to pass a bill to collect the additional receipts or would have to reduce tax rates and, perhaps, make necessary adjustments in planned outlays. If the bill to collect additional receipts were vetoed by the President, and not overridden, it is not clear what would happen next.

The third change in S.J. Res. 58 brought about by the Domenici-Chiles amendment was to require that the Congress and the President ensure that actual outlays not exceed planned outlays through legislation. H.J. Res. 350 simply requires that the Congress and the President ensure that actual outlays not exceed planned outlays. The Domenici-Chiles amendment sought to make it impossible for a President to use this requirement as a justification for expanding his impoundment powers; whether it succeeded ultimately would be for the Supreme Court to decide.

Other Provisions

The final difference between S.J. Res. 58 and H.J. Res. 350 is that the latter proposal still contains a section, which was removed from S.J. Res. 58 on the Senate floor, that "Congress may not require that the States engage in additional activities without compensation equal to the additional costs." This provision was included in the original version of S.J. Res. 58 and in H.J. Res. 350 in order to prevent the Congress from circumventing the intent of the federal sector limitation by shifting responsibilities to other government levels. The Senate chose to drop the section because it felt that the requirement could imply a shift of Constitutional responsibilities from the federal government to the states and could lead to a great amount of litigation.

S.J. Res. 58 and H.J. Res. 350 both contain language defining total revenues--"all receipts of the United States except those derived from borrowing"--and total outlays--"all outlays of the United States except those for the repayment of debt principal." These definitions were included to prevent future Congresses from avoiding the scope of the amendments by shifting programs to off-budget status. Chapter VII discusses whether these definitions can succeed in their purpose.

Finally, both proposals incorporate a two-year implementation period so that the move from the current regime of large deficits to one of planned balances (in the case of H.J. Res. 350) and actual balances (in the case of S.J. Res. 58) could be accomplished without dramatic shifts in budget policy in a single year. Whether a two-year phase-in is enough time to implement these proposals smoothly is discussed in the next chapter.

CHAPTER V. THE EFFECTS OF ANNUALLY BALANCED BUDGETS ON THE ECONOMY AND THE SIZE OF THE FEDERAL SECTOR

Even if the Congress enacts all the proposed expenditure reductions and tax increases called for in the first concurrent resolution for fiscal year 1983, the federal budget probably will run deficits in excess of $150 billion for the next several years. 1/ Thus, the implementation of a balanced budget rule in the near future would require large additional expenditure reductions, large additional tax increases, or both. This is likely to cause severe short-run disruptions in the economy. The first section of this chapter discusses these short-term effects.

Once implemented, however, the effect of a balanced budget rule over the long run is much more difficult to assess since it would bring about such a fundamental change in the institutional relationships by which the federal government tries to moderate economic cycles. Recent economic history, however, can be used to highlight both the potential gains to fiscal policy from having a balanced budget rule (essentially the prevention of fiscal policy errors) and the potential losses (impaired ability to stabilize a declining economy). This is done in the second part of this chapter.

SHORT-RUN EFFECTS ON THE ECONOMY AND THE FEDERAL SECTOR

Serious problems for the nation's economy would arise in the transition from the current deficit budget to the regime of S.J. Res. 58 and H.J. Res. 350. If implemented in fiscal year 1985 (which would require ratification by the states before October 1983), these resolutions would sharply accelerate the trend toward reducing fiscal stimulus that has begun with recent Congressional actions on the fiscal year 1983 budget. 2/

1/ See CBO, The Economic and Budget Outlook: An Update (September 1982).

2/ The Omnibus Reconciliation Act of 1982 (H.R. 6955) and The Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 496).

TABLE 5. PROJECTED FEDERAL DEFICITS (By fiscal year, in billions of dollars)

	1983	1984	1985
April Baseline Projections			
Unified budget deficit	182	216	233
Off-budget spending	21	21	20
Total deficit	203	237	253
First Concurrent Resolution on the Budget for 1983			
Unified budget deficit	104	84	60
Off-budget spending	21	21	20
Total deficit	125	105	80
Budget Resolution Updated by CBO September 1982 Reestimates			
Unified budget deficit	155	152	152
Off-budget spending	18	18	18
Total deficit	173	170	170

CBO's current policy baseline budget projections of April 1982, showed that, even assuming a moderate economic recovery for fiscal years 1983 to 1985, the projected budget deficits would be large and would increase from year to year (see Table 5). (The deficit totals in Table 5 include the outlays of off-budget entities because the proposed amendment requires that they be counted.) By 1985, the total deficit was projected to exceed $250 billion, or 6 percent of GNP. Virtually no economic theory could support a governmental financial structure that showed such high deficits as the economy progressed to a more prosperous state.

As a consequence, the First Concurrent Resolution on the Budget for Fiscal Year 1983 instructed the committees of both Houses to bring forward legislation to raise taxes and lower spending over the period of fiscal years 1983-1985. Projections of the budget under the assumptions of the first concurrent resolution show a substantial reduction in deficits and the elimination of the widening pattern over time.

Since the enactment of the resolution, however, CBO's September 1982 forecast shows that, when the budget estimates are updated to take into account the severity of the current recession (together with small downward revisions in projections of real economic growth and inflation), deficits by 1985 could swell to the range of $152 billion on a unified budget basis and to $170 billion including the off-budget deficits. The September 1982 CBO update incorporates the effects of the 1982 reconciliation and tax acts. This indicates that attaining budget balance by the mid-1980s will be much more difficult than previously thought.

If S.J. Res. 58 and H.J. Res. 350 were ratified by the states before October 1983, their provisions would become effective for fiscal year 1985. This would mean that revenues in 1985 could not exceed an amount derived by applying the growth rate in national income for calendar year 1983 to fiscal year 1984 revenues (unless a specific bill providing for greater revenues was passed by a majority of the whole membership of both Houses). The revenue ceiling would also become the limit on total outlays--including outlays of off-budget entities--under the provision forbidding a planned deficit.

The budgetary and economic implications of these provisions would be severe. The amendment would leave the Congress with two alternatives in the next two years: to cut spending abruptly below the level projected in the first concurrent resolution; and/or to raise taxes sharply above the amounts projected in that concurrent resolution. If the Congress failed to take either action, it would be forced to waive the provisions of the amendment in its first year of implementation. This could be done only by a three-fifths vote of the whole membership of both Houses. Specifically, if CBO's current forecast is accurate, the amendment would require additional spending cuts and tax increases (over and above the cuts and tax increases legislated in 1982) that together would add up to $170 billion, or over 4 percent of GNP.

Impact on the Economy

The effect on the economy of such a shift in taxing and spending in fiscal year 1985 could be severe. The initial reduction in incomes of taxpayers, or of entitlement recipients, or of firms selling goods and services to the government would set off a chain of declining purchases, reductions in output, and job-cutting. This shock would come at a time of nearly 8 percent unemployment, according to CBO's forecast. If the Congress tried to anticipate the problem by partially implementing the tax increases and spending cuts in fiscal year 1984, the changes would begin at a time when the recovery was even younger and the unemployment rate was even higher.

The effects of such a huge reduction in fiscal stimulus on real growth and unemployment could be offset only if real interest rates were to fall sharply and if interest-sensitive sectors of the economy such as housing, were to rebound rapidly. The problem with this scenario for the near future is that CBO's projections of the budget already assume a substantial decline in real interest rates. For example, the three-month Treasury bill rate, corrected for underlying inflation, averaged about 6-1/2 percent in the first half of 1982. CBO now expects it to decline to about half that rate by 1985. A sharp reduction in fiscal stimulus in 1984 and 1985 would put very heavy pressure on the Federal Reserve to bring interest rates down even more, but there might be limits on its ability or willingness to respond. Even if real interest rates did come down, $170 billion in reduced fiscal stimulus would have to be replaced by increased economic activity in the consumer durable, housing, and plant and equipment sectors. While it is not impossible for these sectors to expand so rapidly, the pace of the expansion that would be needed to fill the gap seems overly optimistic.

In short, implementation of the first concurrent resolution already implies significant progress toward correcting the unhealthy budget outlook projected earlier this year. Even if these budget actions brought down real interest rates and strengthened the expected economic recovery, further action along these lines would probably be necessary. It is extremely unlikely, however, that a reduction in fiscal stimulus sufficient to balance the budget as early as fiscal years 1984 and 1985 would be consistent with continued economic recovery.

Impact on the Federal Sector

Cutting an additional $170 billion from the fiscal year 1985 total deficit would be a very difficult task. If a large part of it was done on the spending side of the budget, major dislocations in existing programs would result. As shown in Table 6, under the assumptions of the first budget resolution, by 1985 national defense spending (excluding military retirement benefits) would be about 29 percent of budget outlays, pensions and Medicare would be about 35 percent, and net interest would account for 13 percent. If spending cuts were concentrated in the remaining portion